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VIA AIRBORNE EXPRESS

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Royalty Management Program
Mineral Management Service
Building 85, Denver Federal Center
P. O. Box 25165 - Mail Stop MS-3101
Denver, CO 80225-0165

Dear Mr. Guzy:

RE: COMMENTS ON MMS PROPOSAL -
AMENDMENTS TO GAS VALUATION REGULATIONS
FOR FEDERAL LESSEES - 30 CFR PART 202, 206 AND 211;
60 F.R. 56007 (NOVEMBER 6, 1995)

These comments are submitted on behalf of Shell Oil Company and its subsidiaries, Shell Offshore Inc. and Shell Western E&P Inc. (hereinafter collectively referred to as "Shell"). Shell wholeheartedly supports the substantive concepts which are incorporated into the regulations and commends the MMS for recognizing the tremendous changes which have taken place in the natural gas industry. These changes have completely altered the way gas is sold and transported. Consequently, these changes have impacted calculation of royalty and have left both the agency and lessee with valuation regulations which inadequately address the needs and realities of today's gas marketing world. The negotiated rulemaking forum utilized by the MMS provided a vehicle for receiving input from various interested constituencies which allowed frank and open discussion of the issues. MMS efforts in organizing and guiding the negotiated rulemaking are appreciated.

Although Shell agrees in concept with the proposed regulations, Shell believes that there are several instances in which the consensus of the negotiated rulemaking was not properly incorporated into the proposed regulations, that there are several ambiguities in the regulations which need to clarified and some changes made before the regulations are promulgated.

The alternative valuation method provides for publication of an initial safety net median value (snapshot) and a final safety net median value. It is critically important for the snapshot to be timely published in accord with the consensus in the negotiated rulemaking. It is also equally important that the final true-up value be timely published by the MMS. If the final true-up value is not published then no additional royalty should be assessed. When added royalty is due, interest should not be assessed on

any difference between index and true-up value until the month following the month of publication of the final gross proceeds true-up value. This process follows the royalty payment scheme set out in the lease and would provide sufficient time for the lessee to receive notice, compare, and then tender payment without interest penalty.

Deepwater leases because of their remote location require special treatment. The consensus of the negotiated rulemaking was to provide for the use of alternative valuation options for deepwater gas production by utilizing the zone to which the deepwater production first tied into on the shelf. In addition, for true-up deepwater gas is necessarily reduced in value because of its remoteness from the shelf tie location. Therefore, it was agreed that a transportation adjustment would need to be made in the true-up process for deepwater leases. Both of these concepts are included in the proposed rule but we have offered several suggested changes in order to clarify application of the alternative valuation procedure to deepwater production.

Although the negotiated rulemaking contained a suggested definition of specific geographic zones, it is our understanding that the MMS itself will publish zones in advance of the effective date of the final valuation regulations. Publication of the exact geographic zones and the applicable indices should be done at least ninety (90) days prior to the effective date of the regulations so that lessees may have an opportunity to make informed and timely decisions on which valuation methods to employ.

The notice requested comments on alternatives to the existing benchmarks. Shell believes that a change in the existing benchmarks would be a major undertaking and should be in and of itself the subject of a totally separate rulemaking. The current changes in the gas valuation regulations suggested by the use of index and true-up are sufficiently complicated such that prudence dictate consideration of revisions to benchmarks in a totally separate exercise. We suggest that the MMS publish a separate notice of proposed rulemaking requesting comment on this issue.

Shell appreciates the opportunity to provide comments. Attached are individual specific comments on various portions of the regulations for MMS consideration. We strongly urge that any significant variations from the consensus of the negotiated rulemaking committee be referred back to that committee for discussion prior to final implementation and publication of new regulations.

Sincerely yours,

Peter Velez

P. K. Velez
Regulatory Affairs Manager

MEC:DAD

Attachment

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COMMENTS ON SPECIFIC PROVISIONS OF PRODUCT VALUATION REGULATIONS 60 FEDERAL REGISTER 56007 ET SEQ

202.450(b)(1) - Although §202.450 for the most part tracks the current §202.150(b)(1) adds the following: "However, except as provided in §202.451(b), in no instance will any gas be approved for use royalty free downstream of the facility measurement point approved for the gas." This provision is an addition not included in the 1988 regulations. It fails to recognize that in the offshore environment, it may be to the federal lessor's advantage to provide for royalty free use of production under certain circumstances for secondary and tertiary recovery purposes off lease. The language as proposed does not provide for this exception and should be revised to address it. In fact, it appears to contradict (b)(2) which provides for off lease fuel use as allocated back to an offshore lease. Such use could be after the royalty settlement point.

202.450(c)(2) - The federal lessor does not pay any part of the insurance premiums for lost production. Therefore, any insurance proceeds received for such lost production should not be royalty assessable. Such insurance generally covers only the lessee's share of the production and would not include the lost royalty share.

202.450(d) - This provision begins the use of a new term "operating rights owner". This is a new term introduced in the Definitions section of the proposed regulations is used throughout and it is ambiguous. Lessee is a defined term under the Federal Oil and Gas Royalty Management Act and there's a history of interpretation of this term under the existing 1988 valuation regulations. The introduction of this new term into the regulations raises an ambiguity. There are many varied species of operating rights which are created under oil and gas agreements. Use of the term lessee is adequately certain for purposes of application of the regulations. By definition it is already adequate to address the needs for royalty liability determination. Shell suggests that the term "operating rights owner" be changed to "lessee".

202.450 - Royalty on Gas - This section fails to incorporate the consensus of the negotiated rulemaking committee contained on page 63 of the report which reads as follows:

> "The committee concurred with the MMS proposal that for gas produced from agreements which contain only federal leases with the same royalty rate and funds distribution, and from leases not in an Agreement (stand alone leases), volume and value must be reported and paid on a takes method. The proposal provided for an exception for lessees to request approval to pay on entitlements."

As presently drafted the proposed regulation makes no mention of federal leases with the same royalty rate and funds distributions for volume and value determination on a takes basis. Shell believes that a clear statement should be made in these regulations with regard to this issue in order to incorporate the consensus of the negotiated rulemaking. Most of these situations occur on the Outer Continental Shelf where 80% plus of MMS gas production occurs. Clarity on this issue in the valuation regulations was one of the principal goals of the negotiated rulemaking itself. The issue of "payor liability" is different from the issue of "value and volume reporting" on a takes basis. In addition, in order to remain consistent with the Gulf of Mexico Regional office, the Denver office is requested to review Article 11 of the Model Form of Unit Agreements promulgated by the Gulf of Mexico office which would on its face require royalty payments to be based and calculated upon the production allocated to the leases based on the percentage of participation of each lease in the unit. In other words on entitlement.

206.451 - Definition of Allowance - The definition of allowance should specifically recognize the exception for OCS subsea production which is transported in bulk great distances to a shelf tie-in point. There is no question that this type of movement is indeed transportation based upon the concept of function. Although the committee report of the reg/neg unanimously endorsed this concept, it does not appear in the regulations. In order to avoid ambiguity the exception should be noted in the definition of transportation allowance.

Condensate - Shell has no quarrel with the definition of "condensate" but uses this opportunity to point out that the oil valuation regulations in 30 CFR §202.100(a) specifically provide that royalties due on oil production include condensate separated from gas without processing. In other words, the present oil valuation regulations define condensate as a type of oil product and not gas. In a final promulgation of the gas valuation revisions, reconciliation of this conflict between the oil and gas regulations should be made. This would also apply to Drip Condensate as defined in the regulations.

Entitlement - If Agreement is to be used as a defined term, then when it is used to define other terms and when it is used in the regulations, it should begin with a capital "A". Failure to capitalize occurs in several instances in the proposed regulation.

Operating Rights Owner - As previously noted, this term is ambiguous. The term lessee already includes within its definition this term in the words "this includes any person who has an interest in a lease". Various oil and gas agreements have many different nuances of meaning for operating rights owners. See the definitions given in Williams and Meyers for operating rights owner.

Posted Price - Is an index a posted price? Inclusion of the term posted price in the gas definitions could raise an ambiguity with index leading to confusion in application of the regulations.

Takes - The definition proposed would appear to apply to any person taking gas production under a lease or unit. In application to leases with joint interest or units with multiple interests, takes is generally defined by custom and practice to mean a process in which a co-lessee or unit participant takes production in excess of its entitled share raising issues over the process for determining volume and gas value to be reported to a lessor.

206.454 - Alternative Valuation Standards for Unprocessed Gas and Processed Gas - The commentary on the regulations should recognize under (a)(1)(ii)(b) that the arm's-length gross proceeds received by in an affiliated purchaser's sale need not be lease specific but may be based on type of weighted average value. Today's gas market often specifies sales at specific onshore gathering points from commingled sources flowing from numerous different leases. Although the sale at the commingled point is at arm's-length, it may be necessary to average the price in some fashion back to the various leases flowing to the commingled sales point. It is generally rare to have an affiliated purchaser make a sale from a specific lease. If this provision is not clarified, a lessee meeting the criteria of §206.454 would be restricted to use of index only. This was not the intent of the consensus of the negotiated rulemaking.

206.453(g) and 206.452(g) - These are new provisions which make review, reconciliation, monitoring that results in redetermination nonbinding on the MMS until an audit period is formally closed. It is unclear what the intention of this provision is but on its face it would seem to undermine the finality of directives or reviews of the agency for royalty determination. The proposed regulations should incorporate the provisions contained in the recent MMS policy statement on statute of limitations and should require the agency to meet a clearly defined time period for asserting and collecting royalty payments. Closure of an audit period could take several years despite MMS's intentions to shorten audit turnaround periods.

206.454(a)(6) - Shell adopts the comments included in the API comments made regarding gas contract settlements. Gas contract settlements made prior to the effective date of these amended valuation regulations should not be included as part of the royalty obligation of a lessee. This matter is presently in litigation with conflicting opinions in the Sixth and District of Columbia Circuits with one favoring industry and one favoring the MMS. Final resolution of this matter should be left to the pending judicial appeals. Settlements confected after the date of the amended regulations clearly should not be included as part of the proceeds received for gas since the commentary on the regulations and the regulations themselves have been amended to recognize that index payors do not have any additional gross proceeds obligations. This concept is recognized in §206.453(g) and §206.452(g) (proposed regulation).

206.454(d) - This provision specifies the indices which will be allowed for alternate valuation. MMS should allow a reasonable period for a lessee to detect new indices before making them applicable to valuation. Shell suggests a sixty (60) day period from first publication. It is unlikely that such new publication would contain a large price difference from those indices already existing. However, even a minor change could cause numerous errors and corrections for both the MMS as well as the lessee with little financial benefit but with huge administrative costs to both parties.

206.454(e)(2) - This provision fails to clarify as required in the reg/neg consensus that unappealed orders, Director's decisions and refunds would be included only insofar as they relate to gross proceeds payors and not to index payors. True-up is intended to be a comparison of index to weighted average gross proceeds payor's value. If appeals do not involve gross proceeds payors they should not be used to determine the gross proceeds true-up. If the volumes and values used to determine gross proceeds are not involving prices determined by application of the benchmarks, they should not be included in this provision. See page 34 of the reg/neg consensus which states that the final safety net median value calculation will be based on MMS-2014 data and will include the following data related to gross proceeds based payors and gas RIK reporters.

206.454(e)(3) - Shell supports the exclusion of pipeline settlements from the final safety net median value.

206.454(e)(8) - This provision applies to payors who use index for unprocessed and processed residue gas but pay on a benchmark basis of gross proceeds for plant products. It provides for the comparison of the index value of residue gas and index value of unprocessed gas minus transportation to a final safety net median base value for both gas and gas plant products in the zone. This results in a comparison of index gas without NGLs to gross proceeds gas with NGLs. Comparison of index gas to gross proceeds gas which includes NGL values is inherently unfair. An adjustment should be made in such comparison to only compare gross proceeds gas to index gas with true-up determined by any difference between the two.

206.454(e)(12) - The commentary discussing this provision incorrectly describes the consensus of the reg/neg report. The reg/neg consensus report required that the MMS "will publish a snapshot". The final commentary on this provision should clarify this provision. The publication of the snapshot is an important warning tool to lessees to avoid over assessment of royalty and interest in a final safety net calculation. In the negotiated rulemaking, the lessee's willingness to pay interest was to a large extent based on the early availability of a snapshot.

206.454 - General - Although much of this regulation is devoted to the index based methodology, there is no clear statement contained in the regulation that those payors who opt to use the gross proceeds of the affiliated purchaser are not subject to any type of true-up procedure. A positive statement to this effect should be included in the

final version of the regulations. A clear tie back to the old benchmarks contained in the revised §206.452 and §206.453 should be made for lessees who exercise this option. The reg/neg report on page 33 clearly indicates that payment on net back from a purchasing affiliate's arm's-length gross proceeds is not subject to a safety net comparison.

Deepwater Clarifications

There are several provisions which impact deepwater leases which should be addressed.

206.454(a)(3)(iii) - Clearly clarify the use of alternative valuation by deepwater leases as follows: "(iii) For all leases in a zone or each OCS deepwater lease which ties into a shelf lease in a zone which meets these criteria." This change will eliminate ambiguity on the availability of index valuation for deepwater leases.

206.454(e)(6) - The MMS has requested comments on its failure to timely publish final safety net median value. If the MMS fails to timely publish the final safety net median value for a zone no additional royalty should be due on production from that zone. Notice is needed by the lessee and if it is not given, MMS should forfeit rights to any additional royalty. It is not anticipated that additional royalty will be due. Therefore, failure to publish when no royalty is due would simplify MMS's procedures and the requirement of the lessee to perform comparison. In the alternative, if this is unacceptable, no interest should be due until the month following the month of publication. Interest can only be due from the date when lessee knows of an underpayment. All of the figures necessary to calculate the final safety net median value are in the hands of the MMS. Paying the month following the month of publication tracks logically the requirements for paying royalty on production under current regulations and lease forms. It is unreasonable to assess interest from the very first date of publication since a lessee needs some type of lead time to receive, calculate and pay before interest should be due.

206.454(e)(11) - This provision should be clarified to reflect application of the true-up procedure to deepwater leases as follows:

> "The applicable safety net median value for deepwater leases shall be the safety net median value of the first shelf tie-in point to which the production from the deepwater lease flows. For each deepwater lease on the OCS, any additional royalty which may be due under paragraph (e)(8), (e)(9), or (e)(10) of this section will be calculated only after deducting from the applicable safety net median value the appropriate transportation allowance from the deepwater lease to this first shelf tie-in point within a zone to which the production flows."

It is believed that the above change more clearly expresses application of the safety net procedure to deepwater leases.

206.454(e)(12)(iv) - For the initial safety net median value (snapshot) interest also should not accrue until the end of the month following the month of publication. This added payment responsibility should begin only after a lessee has had an opportunity to perform the comparison and tender payment. To do otherwise is grossly unfair and arbitrarily forcing interest assessments on lessees.

206.454(g)(2) - This should be reworded to more clearly express deepwater leases' ability to utilize zone as follows:

> "However, for purposes of index base valuation deepwater leases may utilize the zone to which the first shelf tie-in is made. Index base calculations shall then be made using the IPP applicable to this shelf lease to which the deepwater lease is tied."

In addition, MMS should publish zones in the Federal Register at least ninety (90) days prior to the effective date of the regulations so that the lessee will have adequate notice in order to decide whether to opt for index base valuation or to set up procedures to properly account for the gross proceeds of its purchasing affiliate.

206.456(a)(1) - MMS is requested to clarify whether PTR (plant thermal reduction) or PVR (plant volume reduction) associated with gas processing would be entitled for valuation purposes to a transportation deduction before valuation for royalty. If a transportation deduction or allowance is available, would it be to the index pricing point or to the tailgate of the processing plant?

206.456(a)(2) - This provision denies compression costs prior to the FMP. In so doing it fails to recognize a real exception for compression for offshore deepwater leases. In these circumstances, compression is absolutely required to move the gas the great distances from the deepwater location to the shelf tie-in point. Compression is required not for pipeline specification purposes but compression is above those specifications to address distance, temperature and the friction of movement. This type of compression should be recognized as the sole exception to this provision. It's sole purpose is transportation. To deny this compression which by purpose is related to transportation would be arbitrary and capricious.

206.457 - These regulations make a distinction based on jurisdictional and non-jurisdictional pipelines regulated by the Federal Energy Regulatory Commission. These regulations may need to be changed to address the present proceeding of the Commission in which it is considering whether the Commission should continue to exercise jurisdiction over OCS pipelines. If the Commission should decline jurisdiction over all OCS gas pipelines, then the basis for the reg/neg consensus would be

changed and the matter should be referred back to the negotiated rulemaking committee for another recommendation. Shell applauds recognition of the non-arm's-length more than 30% use arrayed from the bottom to achieve a rate as well as the recognition of a de minimus rate which recognize the value of transportation services even in non-arm's-length situations.

206.457(d)(5)(iii) - Please add to this provision "as if the production were in fact moving through the line". The reasonable actual cost referenced in §206.457(c) is dependent upon actual movement. Without actual movement there would be no additional cost to calculate under this provision and it would not apply. Without this addition, a lessee would be limited to either the specified rate of 0.03¢ for non-jurisdictional non-arm's-length with less than 30% arm's-length's movement, or for more than 30% arm's-length transportation to the 25th percentile from the bottom of actual third party charges.

206.458 - This provision states that no processing allowance is to be allowed for any plant product valued under §206.454. However, §206.454 provides for the use of gross proceeds of a purchasing affiliate. Therefore, this limitation on use of a manufacturing allowance should be limited to index based payors and not gross proceeds payors under §206.454. To not allow a processing allowance would be inconsistent with §206.454(a)(2)(i) and (ii). If §206.453 gross proceeds procedures are to be used, manufacturing allowances are appropriate.

206.459(c) - Shell fully concurs with the MMS's decision to eliminate the use of transportation and manufacturing allowance forms.